In the Pink

Brown's other windfall tax

Simon Carne explains the pensions problem

Simon Carne is an adviser in regulation with Ernst & Young

After the Budget, actuaries said the removal of advance corporation tax (ACT) credits for pension funds would create a £70bn hole in pensions funds overall. But the stock markets went up – and up again. So, our pension funds are safe. Right? Wrong.

The point is a simple one. The whole science of pension funding can be reduced to one simple equation: benefits = contributions + investment returns. If part of the investment returns is diverted away from the funds by way of a tax that was not there before, either the contributions will have to go up or the benefits will have to go down. Or shares will have to outperform all previous expectations by enough to make up for the taxed amount taken away from the funds.

In this case, that means a 20 per cent improvement in the return on UK equities. Supporters of Gordon Brown, the chancellor, may argue that the markets already anticipating this.

The flaw in this optimistic view is that the markets are simply pricing the marginal sales of shares: when there are more buyers than sellers, the prices go up. (And when there are more sellers than buyers, the price goes down.)

But just because shares in Imperial Chemical Industries have a market capitalisation of about £6bn does not mean you could actually buy the whole of ICI for that price. Nor could its present shareholders expect to realise that much if they all decided to put their holdings on the market at the same time.

You wouldn't even have to put the whole of ICI on the market to test this hypothesis. One investor buying or selling a larger than usual lump of shares in one day can move the price significantly, as Lord Hanson did a few years ago.

Why, then, do people make-believe that pension funds – which, in total, own shares with an aggregate market value estimated at about £700bn (enough to buy ICI 100 times over) – can be objectively said to be worth that figure? The value that will be realised to pay pensions over many decades ahead is not assessed by adding up the prices at which marginal amounts of the assets can be bought and sold today.

To assess the rate of contributions needed to maintain the long-term solvency of a pension fund, actuaries need a more reliable value for the assets held by the funds. Most do this by making some assumptions about the future income from such elements as dividends, rents and interest payments and converting that stream of income into a capital value, using the same assumptions about inflation and interest rates that they use for calculating the capital value of the pensions' liability.

> The loss of tax credits could be bad news for all UK investors

The markets also make assumptions about the future income from the assets (without assumptions, or expectations, there would be no market value). But the markets' assumptions change day by day and even minute by minute, whereas an actuary carries out a valuation only once every three years.

So, an actuary's assessment of pension fund liabilities is usually made using more stable assumptions than the market does to price its transactions (except when cashing in a pension in exchange for a lump sum transfer, when the actuary's slowly changing assumptions could give a misleading price. In this case, actuaries do use market-based assumptions for calculating transfer values out of a pension scheme).

There is nothing, in principle, to stop an actuary from using more market-like assumptions. But that would just lead to the calculated value of the liabilities swinging around with all the volatility inherent in the stock market's changes of mind.

In the US, that is rather closer to what actuaries are required to do, at least for the purposes of calculating pension liabilities in company accounts. Some smoothing of the results is allowed, although not as much as in the UK. It is far from clear that the resulting swings and roundabouts in the calculated value of pension liabilities are helpful to anyone.

So, where does that leave UK pension funds after the Budget? Andrew Wilson of actuary Watson Wyatt estimates that the loss of tax credits will add about £70bn to the cost of UK schemes. He believes about £5bn a year more needs to be contributed to the funds for the next 10 years, with a lower additional figure after that.

Set this figure against the rate at which employers are contributing to pension schemes now – probably less than £10bn a year – and it becomes very clear that they might well decide not make up the extra. That would mean weaker funding of pensions: in other words, lower security for members, or lower pensions on retirement.

Coincidentally, 1997 is the first year in which recent legislation requires companies to maintain minimum levels of security in their pension schemes. If the Department of Social Security wants to raise the security level to compensate for the loss of future investment income, it might find itself in conflict with the Treasury, which clearly wants to see more reinvestment in companies, not higher pension contribution rates.

Without that reinvestment, the chancellor's whole strategy for enhancing UK plc's competitiveness could be shot to bits. And that would make the loss of tax credits bad news for all UK investors, not just for those in pension funds.